

BEFORE THE  
Federal Communications Commission

WASHINGTON, D. C.

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JAN 27 1993

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of  
  
Implementation of  
the Cable Television Consumer  
Protection and Competition Act  
of 1992

MM Docket 92-266

Rate Regulation

COMMENTS OF TIME WARNER ENTERTAINMENT COMPANY, L.P.

Aaron I. Fleischman  
Charles S. Walsh  
Arthur H. Harding  
Fleischman & Walsh  
1400 Sixteenth Street, N.W.  
Suite 600  
Washington, D.C. 20036

Philip L. Verveer  
Sue D. Blumenfeld  
Francis M. Buono  
Willkie Farr & Gallagher  
Three Lafayette Centre  
1155 21st Street, N.W.  
Suite 600  
Washington, D.C. 20036-3302

Its Attorneys

January 27, 1993

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Daniel Kelley, The Economics of Cable Television Regulation  
(January 27, 1993)

## SUMMARY

Congress has directed the Commission to develop a regulatory scheme for cable television. While the Cable Act of 1992 plainly reflects a judgment that cable television rates need to be more closely regulated than the Commission decisions would have permitted, Congress nevertheless has given the agency substantial discretion in crafting the dimensions of the regulatory regime. This discretion must be exercised pursuant to several key guiding principles.

\* **Simplicity.** The overall regulatory approach and its implementing tools must be as simple as possible. Complexity in this context not only adds to the direct costs of administration and compliance, it produces substantial indirect costs of uncertainty, diminished innovation, and reduced investment. The Commission has already recognized this in its tentative rejection of rate of return regulation.

\* **Efficiency.** The regulatory framework should adjust appropriately to the particular costs and benefits of regulating a particular set of cable services and/or equipment. This follows the overall framework of the statute, which calls for a comprehensive regulatory schema for the basic service tier (and related equipment), but only regulation by exception in its "bad actor" approach for what Congress found to be a more competitive environment for expanded basic services. Finally, the Act provides that pay services and equipment must be free from regulation entirely.

\* Flexibility. The regulations which the Commission promulgates in this proceeding will develop out of an industry picture taken prior to making the adjustments required by the 1992 Act. Substantial reconfiguration of services, rate structures, and rate levels will be required as a result of the Act and the Commission's implementing rules. Realistically, equilibrium will not return until after the industry has "lived" under regulation over some transitional time period.

With these principles in mind, Time Warner urges the Commission to adopt a regulatory framework in which:

- Basic service tier rates are regulated by a benchmark approach. The benchmark would be adjusted over time by a properly crafted index;
- Expanded basic tier rates would be subject to regulatory scrutiny only if they fall outside a set industry norm, a so-called "outlier" approach. In years following 1993, the outlier analysis would be performed on the basis of industry increases rather than industry rates;
- Rates for video programming offered on a per channel or per program basis (*i.e.*, "premium programming service") and the equipment used to receive such programming are wholly unregulated;
- Minimal federal rate regulatory procedures are established and local franchise agreements are allowed to control the basic service tier regulatory process, subject only to their compliance with the minimal procedural requirements set forth in the Act;
- Equipment would be subject to regulation depending upon the category of service subscribed to by the subscriber, with only the actual equipment used by basic tier-only subscribers directly regulated;
- Leased access rates must not be governed in a way that will defeat the statutory goal of diversity. The maximum reasonable rate standard should be implemented

by reference to fees implicitly paid by programmers already on the system; and

- A flexible implementation approach affords cable operators ample time to make the myriad changes necessary to bring their systems into compliance with the Commission's new rules.

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COMMENTS OF TIME WARNER ENTERTAINMENT COMPANY, L.P.

Time Warner Entertainment Company, L.P. ("Time Warner"), by its attorneys, hereby files its comments in the above-captioned proceeding<sup>1</sup> to develop regulations pursuant to which cable services may be regulated. Time Warner is a partnership, which is primarily owned (through subsidiaries) and fully managed by Time Warner Inc., a publicly traded Delaware corporation. Time Warner is comprised principally of three unincorporated divisions: Time Warner Cable, which is the second largest operator of cable television systems nationwide; Home Box Office, which operates pay television programming services; and Warner Bros., which is a major producer of theatrical motion pictures and television programs. Time Warner Cable, which owns and operates cable systems in approximately 1,500 franchise areas through the United States, will be directly affected by rules the

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<sup>1</sup> Notice of Proposed Rule Making in MM Docket 92-266, FCC 92-544 (released December 24, 1992) ("Notice").

Commission adopts regarding the regulation of cable rates. Time Warner is therefore an interested party in this proceeding.<sup>2</sup>

The importance of this proceeding to the Commission's statutory mission, to cable consumers, and to the cable industry cannot be overstated. This statement can be made with confidence for one simple reason: The substantial consumer benefits from the explosive growth of cable systems and cable programming are at risk here if the Commission does its job poorly.

#### I. OVERVIEW OF RATE REGULATORY SCHEME

The Act defines three categories of cable television programming -- basic service tier, cable programming service, and premium programming service<sup>3</sup> -- and provides different rate regulation treatment for each. Subsection 623(b) of the Act regulates a "basic service tier" that cable operators must make separately available for their customers. This basic tier must include at a minimum local television broadcast signals carried by the cable system, as well as

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<sup>2</sup> In its pending action against the Commission, Time Warner Entertainment Company, L.P. v. F.C.C., Civil Action No. 92-2494 (D.D.C. filed Nov. 5, 1992), Time Warner takes the position that the rate regulation requirements, inter alia, of the 1992 Cable Act are unconstitutional in that they impose speech restrictions on cable operators which directly contravene the fundamental precepts of the First Amendment. Time Warner also believes that the regulation set forth in the Act is unnecessary; there is no need for government intervention when, as here, competitive market forces prevail. In submitting these Comments, Time Warner specifically reserves and it does not waive its constitutional rights, and these Comments are filed without prejudice to Time Warner's legal challenges.

<sup>3</sup> "Premium programming service" defines video programming offered on a per channel or per program basis.

public, educational, and governmental access programming.<sup>4</sup> The Commission is instructed by the Act to promulgate regulations to "[e]nsure that the rates for the basic service tier are reasonable"<sup>5</sup> and do not exceed the rates that would be charged for the basic service tier if the cable system were subject to "effective competition."<sup>6</sup>

In contrast to the comprehensive regulatory scheme which Subsection 623(b) mandates for the basic service tier, Subsection 623(c) provides for a qualitatively different type of regulatory program for "cable programming services."<sup>7</sup> The Act does not require the Commission to prescribe reasonable rates for such services. Instead, Subsection 623(c) instructs the Commission to establish criteria "[f]or identifying, in individual cases, rates for cable programming services that are unreasonable."<sup>8</sup> The Commission may then order reduction of rates for cable programming services it determines

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<sup>4</sup> Cable Television Protection and Competition Act, Pub. L. No. 102-385, § 623(b)(7), 106 Stat. 1460 (1992) ("1992 Cable Act").

<sup>5</sup> Id. § 623(b)(1).

<sup>6</sup> Id.

<sup>7</sup> A "cable programming service" is any video programming other than (i) video programming which is on the basic service tier described above and (ii) video programming "[o]ffered on a per channel or per program basis." Id. § 623(1)(2). The definition of cable programming service also encompasses the installation and rental of equipment used for the receipt of any video programming which is a cable programming service. Id.

<sup>8</sup> Id. § 623(c)(1)(A).

to be unreasonable upon a complaint from a subscriber or franchising authority.<sup>9</sup>

In short, the basic service tier and cable programming services are subject to very different regulatory approaches. Rates for the basic service tier are subject to proactive regulation under Section 623(b) to ensure their reasonableness. Rates for cable programming services are subject to reactive regulation under Section 623(c) to reduce rates which are found upon complaint to be unreasonable: Cable programming services are thus to be regulated by exception only.

Finally, premium programming services are not subject to regulation under the Act since such programming is not within the basic service tier and is excluded from the definition of cable programming services.<sup>10</sup> Nor are these pay channels transformed into cable programming service and subject to the outlier complaint process simply because they are packaged and offered to subscribers on a discounted basis.

This statutory scheme is motivated by and reflects Congress' paramount concern that local television broadcast signals and public, educational, and governmental access programming be accessible to the greatest possible number of homes passed.<sup>11</sup> Stated otherwise, the Act reflects a decision to regulate directly the "antenna service" aspects of cable television only. Congress judged that as a subscriber moves

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<sup>9</sup> Id. § 623(c)(1)(C). The Commission is authorized to order refunds pursuant to this subsection.

<sup>10</sup> See id. §§ 623(b)(7) and 623(1)(2).

<sup>11</sup> Id. §§ 2(a)(17) and 2(a)(19).

beyond the basic service tier to cable programming services and then to premium programming the governmental interest in assuring accessibility by regulating rates is substantially diminished in the first case and non-existent in the second.

The regulation of equipment rates under the Act likewise reflects this stratification. The services and equipment used by a subscriber receiving only the basic service tier are subject to proactive rate regulation under Subsection 623(b). The services and equipment of a subscriber who elects to purchase cable programming services are subject to the case-by-case reduction of "unreasonable" rates under Section 623(c). In promulgating rules for the regulation of cable services and equipment, the Commission must work within this overall framework set out in the 1992 Cable Act.

## II. STANDARDS AND PROCEDURES FOR IDENTIFYING CABLE SYSTEMS SUBJECT TO EFFECTIVE COMPETITION

The 1992 Cable Act establishes an overall preference for competition over regulation.<sup>12</sup> The Act permits regulation of a cable system's subscription rates only if the Commission finds that the cable system is "not subject to effective competition." A cable system is deemed to be subject to effective competition if any one of the following three standards is met. The first standard is met if less than 30% of the households in the franchise area subscribe to cable service.<sup>13</sup> The second standard is met if two conditions are satisfied: (1) there are in the franchise area "at least two unaffiliated

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<sup>12</sup> Id. § 623(a) entitled "Competition Preference;" (a)(2) entitled "Preference for Competition."

<sup>13</sup> Id. § 623(1)(1)(A) (emphasis added).

multichannel video distributors each of which offers comparable video programming to at least 50% of the households in the franchise area;"<sup>14</sup> and (2) the number of households that subscribe to such distributors, excluding the largest distributor, is greater than 15% of the total number of households in the franchise area.<sup>15</sup> The third standard is met when the franchising authority is itself a multichannel video program distributor and offers its programming to 50% or more of the total number of households in the franchise area.<sup>16</sup>

The effective competition standards to be promulgated by the Commission should reflect the realities of cable television service and its competitive environment. A cable television operator in a single franchise area may serve many different types of customers, from a single family home to a multi-story apartment complex. The cable operator faces competition from many different sources which may target diverse segments of the cable franchise area. The Commission should base its determination of "effective competition" with these industry realities in mind.

A. The 30% Penetration Test Should Apply to All Homes in the Franchise Area

Time Warner agrees with the statement of the Notice that effective competition should be found to exist where less than 30% of the homes in the franchise area subscribe to cable television service.<sup>17</sup> The

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<sup>14</sup> Id. § 623(1)(1)(B)(i).

<sup>15</sup> Id. § 623(1)(1)(B)(ii).

<sup>16</sup> Id. § 623(1)(C). These same standards are described in the Notice at ¶ 7.

<sup>17</sup> Notice at ¶ 7.

statute clearly establishes that the relevant base is the "households in the franchise area."<sup>18</sup> Thus, considerations of how many homes are actually passed by the cable system or whether the operator is required to build cable plant to all portions of the franchise area are not relevant for the first effective competition test.

B. Competition Faced by Cable Operators From Various Technologies Requires Tailoring of the Effective Competition Determination

The second test for effective competition measures the effects on the cable operator's service by rival multichannel video programming distributors. The cable operator may face competition from such multichannel video programming distributors as other cable operators, multichannel multipoint distribution service ("MMDS"), television receive-only satellite program distributors ("TVROs"), direct broadcast satellite ("DBS"),<sup>19</sup> satellite master antenna television ("SMATV"),<sup>20</sup>

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<sup>18</sup> 1992 Cable Act § 623 (1) (1) (A).

<sup>19</sup> Cable operators, MMDS, DBS, and TVROs are statutorily defined as "multichannel video programming distributor[s]." Id. §602(12). Services that are statutorily defined as such should be considered multichannel video programming distributors regardless of the number of channels these services choose to market.

<sup>20</sup> Although SMATV is not specifically mentioned as an example of a "multichannel video programming distributor" in §602(12) of the Act, it does meet the general definition of one who "makes available . . . multiple channels of video programming." In addition, Congress has recognized that SMATV systems are essentially private cable systems that "utilize the same technology and satellite reception capabilities as the larger municipally franchised cable system." S. Rep. No. 67, 98th Cong., 1st Sess. 19 (1983). See also, H.R. Rep. No. 934, 98th Cong., 2d Sess. 22 (1984) (SMATV systems are potential competitors of cable systems).

telephone video dialtone service,<sup>21</sup> and local multipoint distribution service ("LMDS").<sup>22</sup> These alternative providers vary in their approach to service and often target only a segment of the total population in the community. Thus, the cable operator may face greater degrees of competition from various multichannel video providers in different segments of the franchise area. Commission rules need to be flexible in extending unregulated status to cable operators in any segment where the effective competition test is satisfied.<sup>23</sup>

Of particular concern to Time Warner is the level of discrete competition that occurs for subscribers in multiple dwelling units

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<sup>21</sup> Video dialtone service would permit video programmers to use the local telephone access to households to "provide either single or multichannel services." In the Matter of Telephone Company - Cable Television Cross-Ownership Rules, Sections 63.54 - 63.58, Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking, 7 F.C.C. Rcd 5781, ¶ 2, n. 3 (1992). If multiple channels of video programming are offered, video dialtone is just as viable a competitor to cable service as MMDS, DBS, or SMATV and should be considered a multichannel video programming distributor.

<sup>22</sup> The Commission has not yet licensed LMDS service. However, the Commission has recognized that the most significant use of LMDS service will be to provide video services in competition with cable television operators. Rulemaking to Amend Part 1 and Part 21 of the Commission's Rules to Redesignate the 27.5 - 29.5 GHz Frequency Band and to Establish Rules and Policies for Local Multipoint Distribution Service, Notice of Proposed Rulemaking, Order, Tentative Decision and Order on Reconsideration, CC Docket No. 92-297, ¶ 16 (released January 8, 1993).

<sup>23</sup> Such flexibility will fully comport with Congress' expressed preference for competition over regulation. 1992 Cable Act § 623(a)(2). See also, H.R. Rep. No. 628, 102d Cong., 2d Sess. 34 (1992) ("House Report") ("a fully competitive marketplace ultimately will provide the most efficient and broadest safeguards for consumers.").

("MDUs").<sup>24</sup> For example, a franchise area may contain many MDUs that are capable of being served by both the franchised cable operator and a SMATV or MMDS operator. The SMATV or MMDS operator may have no plan to offer service throughout the franchise area and is under no franchise obligation to offer such services. In many communities, MDU households are a minority of the total number of households and so the SMATV or MMDS operator can offer service to every MDU without triggering the 50% margin of the second standard. Competition for MDU customers, however, is often particularly heated.

Effective competition rules that would consider an entire franchise area as a homogeneous whole and blindly impose rate regulation as to the MDU segment would not be in the public interest. By applying the rules in this way, competition declines because the regulated cable operator cannot freely compete with an unregulated SMATV operator. Instead, the Commission should encourage competition by allowing cable operators to have unregulated status for MDU services altogether. At a minimum, where competitive video programmers meet the 50% and 15% measures with respect to the MDU segment of the franchise area no regulation should attach.

To measure more accurately the level of competition for MDU residents, the definition of "households" should include, in accord with normal usage, the number of individual dwelling units in each such

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<sup>24</sup> For purposes of this discussion, MDU is intended to encompass both pooled residences (apartment buildings, condominiums, etc.) and non-residential customers (hotels, bars, hospitals, etc.). In either category, there are ready alternatives to the cable operators such that market-based rates can be unregulated.

facility in the franchise area. The Notice states that, with respect to the second and third tests for effective competition, "[w]e plan to count each separately billed or billable customer as a 'household'. . ."<sup>25</sup> Billing, however, is not an adequate measure of the total number of separate dwellings that pay for access to cable television. In the case of MDUs, the apartment dweller may pay its landlord for the right to service or it may be incorporated within the rental fee. Under the Notice's definition of household, these MDUs may only be counted once if the cable operator bills only the landlord on a "bulk" basis in contradiction to the clear meaning of the statute. Alternatively, the landlord may not have such an agreement with the cable operator and so each apartment dweller would be counted as an individual household under the Notice's definition. The Commission should follow the clear meaning of the statute and take MDU agreements into account and adopt a definition that counts each dwelling unit as a "household."

Commission rules should be drafted to reduce the potential for manipulation of the effective competition standard by rival video programmers. In the Notice, the Commission tentatively concludes that 50% of the households are "offered" video programming when it is "actually available" to those households.<sup>26</sup> This standard, however, could permit the competitive video distributors to control whether the cable operator is subject to rate regulation. To foster competition, the Commission should deem that rival video programmers "offer" programming to a household when they are technically capable of

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<sup>25</sup> Notice at ¶ 8.

<sup>26</sup> Id.

providing their service to that household.<sup>27</sup> Thus, a rival multichannel video programming distributors would have no artificial incentive to refuse service to particular customers. Under this definition, a rival may reach the 50% "offer" threshold when it first begins service, although the effective competition test would still not be met. However, when aggregate rival subscription levels hit 15% of the households of the franchise area, the effective competition test would be satisfied.

The statutory definition refers to competitors which offer "comparable" video programming and the Notice seeks comment on whether a minimum amount of programming or number of channels is necessary to be deemed comparable to cable television service for purposes of the second standard for effective competition.<sup>28</sup> The Notice seeks comment on the approach that presumes competitive services to offer comparable video programming if the competitive services reach levels of subscriber penetration of 15% or greater.<sup>29</sup> Considering the subscriber's numerous video options in the current highly competitive environment, including the off-air availability of free broadcast television, this presumption is sound. If competitors are gaining at least 15% of potential subscribers, Time Warner urges the Commission to

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<sup>27</sup> The legislative history shows that Congress contemplated a "technically capable" standard. In the Senate debate on the Conference Report, Senator Lieberman posed a hypothetical to Senator Inouye in these terms when referring to the 50% benchmark: "an unaffiliated DBS provider is capable of providing comparable service to the entire franchise area." 138 Cong. Rec. S.14253 (daily ed. Sept. 21, 1992) (emphasis added).

<sup>28</sup> Notice at ¶ 9.

<sup>29</sup> Id.

presume that the competitive services must be deemed comparable to cable television services or otherwise they would not have achieved such high consumer acceptance. Any other interpretation would require the Commission to embark upon the slippery slope of attempting to make content-based determinations of comparability.<sup>30</sup>

### III. REGULATION OF THE BASIC SERVICE TIER

#### A. Components of the Basic Service Tier Subject to Regulation

The Notice seeks comment on what components should comprise the basic service tier.<sup>31</sup> Time Warner submits that this question is answered directly by the statute itself: The basic service tier must include the broadcast signals (other than the superstations) and the PEG channels.<sup>32</sup> The statutory language of Section 623(b)(7)(A) is unequivocal and need not be changed for purposes of administrative implementation.

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<sup>30</sup> The Notice also seeks comment on whether the 15% threshold may be met by accumulating the market shares of two or more competitors to the cable operator. Id. at ¶ 9 and n. 15. The statute clearly provides that the 15% test is to be determined by calculating the percent of total households "subscribing to programming services offered by multichannel video programming distributors other than the largest multichannel video programming distributor." 1992 Cable Act § 623(l)(1)(B)(ii) (emphasis added). See also, 138 Cong. Rec. S.14253 (daily ed. Sept. 21, 1992) (In the colloquy between Senators Lieberman and Inouye, the example of two DBS providers, each with 10% of the households in the franchise area, does not meet 15% test because one DBS provider is affiliated with the cable operator. The implication from this example is that without the affiliation, the shares would be accumulated as 20%).

<sup>31</sup> Notice at ¶ 11.

<sup>32</sup> See 1992 Cable Act § 623(b)(7)(A)(i-iii).

The statute also permits, at the election of the cable operator, the addition of other signals or services to the basic tier.<sup>33</sup> Where a cable operator so elects, these additional services are subject to regulation. It is far from clear under what conditions a cable operator would affirmatively choose to subject a service to regulation. The Commission should make absolutely plain, however, that this subsection does not interfere in any way with a cable operator's right to retier services out of the basic tier as a reasonable response to the new regime.<sup>34</sup>

The statutory definition of basic service tier should also be read to preempt any franchise agreement requirement to the contrary. Under a new regulatory regime which directly constrains the rates for a specific set of services in order to promote localism, cable operators should not be bound by anachronistic requirements for a "fat" basic tier. Congress plainly envisioned that cable operators would have the choice to put satellite networks onto "cable programming services" tiers, and thereby have them subject to a much less constraining regulatory scheme. Thus Congress intended to make available a low-cost, low-priced basic tier. The Commission should thus declare any local requirements which specify either the content composition or a fixed number of channels for the basic tier to be preempted.

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<sup>33</sup> Id. § 623(b)(7)(B).

<sup>34</sup> See discussion infra, section VII. D., of 1992 Cable Act § 623(h) (dealing with prevention of evasions, including by retiering).

B. Regulation of Rates for the Basic Service Tier

1. Rate of Return Regulation Should Be Rejected As a Regulatory Approach for the Basic Service Tier

a. The Costs and Administrative Burdens Attendant to Rate of Return Regulation Counsel Against Its Adoption Here

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In evaluating the possible regulatory schemes for regulation of basic service tier rates under the 1992 Cable Act, the Notice sets forth alternatively rate of return regulation and benchmarks. These alternatives and their respective potential benefits and costs are discussed at length in the attached analysis of Dr. Daniel Kelley of Hatfield Associates, Inc.<sup>35</sup> Because this analysis is crucial to the Commission's ultimate determination, Time Warner highlights the principal points below.

Dr. Kelley sets forth as his underlying premise:

Government intervention in cable television carries with it the potential to do significant harm to an industry that has been performing quite well along a number of significant public policy dimensions. Therefore, the objectives of the 1992 Cable Act must be carefully specified and the least intrusive possible regulatory tools for accomplishing those objectives must be identified.<sup>36</sup>

Based on this premise, Dr. Kelley urges the Commission to avoid rate of return regulation for basic cable rates:

There are several reasons why rate of return regulation for basic cable rates would not work. First, cable companies do not have a cost structure like that of a traditional public utility. Cable programming costs, which are a significant input, vary greatly among systems and can be controlled by cable operators through their program selection. Second, and

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<sup>35</sup> Daniel Kelley, The Economics of Cable Television Regulation, January 27, 1993, submitted with Time Warner's Comments as Attachment ("Kelley").

<sup>36</sup> Id.

related to the first point, cable television companies offer an extremely heterogenous set of services, making company-to-company or year-to-year comparisons difficult. Cross-company and cross-time comparisons are an essential component of the enforcement of local exchange carrier cost of service regulation. Third, the cable television industry and its potential regulators are extremely fragmented. There are potentially significant fixed costs of regulation that would be incurred by every cable system and every regulator. Fourth, unlike most regulated utility services, cable television is not a bottleneck on which other critical businesses depend for service or a necessity that consumers cannot avoid purchasing. Finally, and related to the last point, demand for cable services is likely more elastic than the demand for traditional public utility services such as water, electricity and local telephone service.<sup>37</sup>

Conversely, Dr. Kelley strongly endorses a benchmark approach for regulating basic cable rates:

The Commission is correct that the use of benchmark regulation would be superior to rate of return regulation. Benchmark regulation will provide an efficient, administratively simple regulatory framework, thus satisfying the Congressional desire to minimize regulatory burdens on both regulators and regulated companies. In addition to minimizing the resource cost of regulation, benchmarks will provide cable operators with a degree of regulatory certainty, thus allowing them to plan and operate their businesses against known constraints rather than the unknown constraints that will be generated by a rate of return process that will take some time to develop.<sup>38</sup>

The costs inherent in rate of return regulation are already well-understood by this agency. Indeed, these costs were the primary reason why the Commission sought out incentive regulation as a possible alternative regulatory approach. In its Price Cap proceeding, the Commission identified one of the primary costs, if not the most critical cost of rate of return regulation, namely the distorted incentives it creates for the regulated firm:

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<sup>37</sup> Id. at 18-19.

<sup>38</sup> Id. at 20.

[C]ompetition ... causes each firm constantly to seek out cost savings, demand opportunities, and innovations that allow it to gain advantage over competitors, or at least to keep up with others who are themselves striving for advantage. This process results in each firm minimizing its long-run cost of production, and it is this incentive to operate efficiently that is at least partially sacrificed under rate of return regulation.<sup>39</sup>

Quoting directly from Professor Alfred Kahn, the Commission continued its critique of rate of return regulation:

The negative character of a regulatory process that concentrates mainly on the rate of return of aggregate company investment entails several inadequacies or adverse consequences. It means that regulation as such contains no built-in mechanism for assuring efficiency.... [It] tends to take away any supranormal returns [the companies] might earn as a result of improvements in efficiency, thereby diminishing their incentive to try. And if it permits them to earn only the cost of capital, it creates a situation in which any inefficiencies can simply be passed on in higher rates without injury to existing shareholders.<sup>40</sup>

The distorted incentives leading to higher costs and thus higher rates to consumers were also analyzed. These flow both from incentives to pad the rate base, the so-called "Averch-Johnson" effects, as well as the absence of any incentive in management to minimize expenses, known as "X-inefficiencies." The Commission concluded that in both cases "consumers suffer because these distorted incentives increase the cost of doing business -- and thus the rates consumers must pay for service."<sup>41</sup>

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<sup>39</sup> Policy and Rules Concerning Rates for Dominant Carriers, 3 F.C.C. Rcd 3195, 3219 (1988).

<sup>40</sup> Id. (quoting A. Kahn, The Economics of Regulation at 48 (1971)).

<sup>41</sup> Id. at 3219-3220.

b. Rate of Return Regulation Will Stifle the  
Technical Dynamism of the Cable Industry

The observations made by Professors Alfred Kahn and Irwin Stelzer over one decade ago, in the context of making recommendations to then New York Governor Hugh L. Carey regarding the appropriate regulatory environment for New York State communications industries, applies today with equal force:

[C]able is undergoing the most dramatic development from a simple system for importing distant signals into remote and sparsely populated areas to two-way communications systems providing a wide range of informational, entertainment and business services.... This is precisely the kind of dynamic situation in which the application of traditional regulatory concepts and techniques is most likely to obstruct the full development of that potential.<sup>42</sup>

The Report continued, recommending that regulation of cable rates be limited exclusively to the basic tier consisting of the importation and distribution of a number of signals, and further, that the form of regulation remain as

a kind of pragmatic bargaining process between the local bodies and the cable companies. Specifically, we would strenuously resist any attempts to convert it to the traditional public utility mold, basing allowable rates on an acceptable return on invested capital, with all its inescapable paraphernalia of uniform systems of accounts, valuation of rate base, allocations of investment and operating costs between "basic" and other services, and estimation of cost of capital.<sup>43</sup>

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<sup>42</sup> Telecommunications in New York State: Redefining the Role of Government, New York State Executive Chamber Office of Development Planning (1981), Appendix B (Memorandum of March 25, 1981 from Alfred E. Kahn and Irwin M. Stelzer to Governor Hugh Carey) (emphasis added).

<sup>43</sup> Id.